COMMITTEE ON FINANCE
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Max Baucus, Chairman
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For Immediate Release
July 31, 2007

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Statement of Senator Max Baucus (D-Mont.)
Finance Committee Hearing on Carried Interest

The Apostle Paul wrote of this world: "Now we see through a glass, darkly."

We could say much about the world of hedge funds and private equity. The world of hedge funds and private equity is opaque.

Today, we will hold our second hearing on carried interest. We will try to shine a little more light through the glass on the operation of private equity, hedge funds, and real estate funds.

Private equity funds use a variety of strategies. They acquire companies and take them private. They provide structured financing for deals. Because private equity funds are not transparent, some misunderstand what private equity managers do. These hearings will try to help us to see some more facts.

We see how private equity has a tremendous appetite for taking companies private. The cup of coffee from Dunkin' Donuts is produced by a company held by private equity. Private equity funds have incredibly diverse holdings, from hotel chains to toy stores.

The ability of private equity funds to grow and expand is impressive. These are fantastic times for private equity.

Hedge funds serve an important role. They manage nearly $2 trillion in assets. Much of that money comes from pension funds, foundations, endowments, and other non-profit corporations. The returns of some funds are stellar. Some funds create tremendous wealth for investors and managers alike.

The strategies that hedge funds use are not transparent. There's a reason for that. Very bright managers spend a great deal of time creating strategies to generate these returns for their investors. They want to keep those strategies secret. They would prefer that other managers not replicate their strategies.

But secrecy can also increase risk. We will try to see how risky some hedge fund investments are. Take, for example, leverage, the amount of debt that hedge funds take on to enhance their investing capacity. There is a lot of misinformation — or downright disinformation — about how hedge funds use leverage to achieve investment goals.

I talk about disinformation because at a meeting in this very building, a hedge fund association implied that leverage in hedge funds is 1-to-1 — that is, that they are borrowing about as much as they hold in equity.

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The reality is that hedge funds are generally leveraged at a minimum of 3-to-1, and more likely are leveraged at least 10-to-1. That is, they are borrowing 3 to 10 times what they hold in equity. And the public does not know the amount of leverage in any of these deals.

There is leverage at the fund level. And then depending on the strategies employed, the securities themselves can be highly leveraged.

I hope that we can have an honest discussion. And I hope that the many lobbyists employed by hedge funds and private equity will not make the glass even darker than it already is.

A manager of a fund receives two types of income: a management fee of around 2 percent of the capital and a carried interest of 20 percent of the profits. The management fee is generally taxed at the ordinary income rate.

A carried interest is an interest that the manager has in the profits of the investment partnership.

The manager receives the interest when the fund is created. And the manger receives payment on that interest only after the initial investment is returned to the outside investors and the fund exceeds a certain level of profit.

As we discuss whether income from a carried interest should be treated as income from a service or receive the character determined at the partnership, there are also issues that can cloud the view.

For example, many private equity fund managers convert portions of their management fees into additional carried interest. Some managers aggressively convert management fees into carried interest on a quarterly or annual basis.

And many hedge funds use Cayman Island or other offshore corporations to bring in foreign and nonprofit investors. For the offshore part of the fund, the manager receives an incentive fee of 20 percent of the profits from the foreign side of the fund. This fee is taxed at the ordinary income rate.

For the domestic part of the fund, the manager has a 20 percent carried interest that is taxed as capital gains income. Economically, I do not see the difference between the incentive fee and the profits interest. Both give the manager 20 percent of the profits.

There is little difference between a large private equity firm and a Wall Street investment bank. Both offer merger and acquisition services. Both provide mezzanine financing for transactions. Both offer a wide array of investment strategies for their clients. But only one claims that the income from an active business is passive and is subject to capital gain treatment.

Once again today, we have a balanced panel of actual managers of alternative investment funds who can discuss how a profits interest plays a role in their deals.

For now, we may see through a glass, darkly. But we will try to see face to face. For now, we may know in part. But we will try to know more completely. And we can hope — perhaps with a little charity, and maybe a little change — that our faith in our tax system will abide.

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